

VIDEO PROGRAMMING COSTS AND CABLE TV PRICES

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I. INTRODUCTION

1. Cable television companies (sometimes referred to as multi-system operators, or “MSOs”) sell television programming, broadband and telephone services, and ancillary products (like installation services and DVR rentals) to consumers, typically for a monthly subscription fee. To create these products, they procure inputs, such as network equipment from equipment manufacturers, trucks from automobile companies, long distance telephone connections from other telephone companies, and video programming from cable and broadcast television producers.

2. Video programming is an especially important input. While broadband and telephone services generate a growing share of MSO revenues, video (i.e., cable TV service) is still responsible for the lion’s share of the total; indeed, video remains the MSOs’ “killer app,” enabling them to dramatically increase revenues (and margins) by selling add-on broadband and telephone services. Without programming – from *60 Minutes* to *Dancing with the Stars*, from *Monday Night Football* to *Mad Men* – cable television operators literally would not exist in their present form.

3. Cable operators can and do produce their own programming. For example, Comcast is one of the leading operators of regional sports networks, as well as owning national networks such as the Golf Channel, E! Entertainment, and VERSUS;¹ and, it is seeking to acquire NBC. However, most of the programming carried on cable (including both broadcast programming and cable programming) is produced by unaffiliated companies like News Corp., CBS, Viacom, and The Walt Disney Company (“Disney”). MSOs negotiate with programmers such as these for program rights to cable content, and for retransmission consent rights to

1. Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Thirteenth Annual Report, MB Docket No. 06-189 (Jan. 16, 2009), Appendix C, Table C-1 [hereafter *Thirteenth Annual MVPD Report*].

broadcast signals.² For programmers like Fox, NBC and Disney, which own both cable programming and broadcast stations, it is typical for the negotiations for cable programming and broadcast signals to occur simultaneously.³

4. As a general matter, cable operators (like any business) would prefer to pay lower prices for inputs, including programming, since lower input costs would translate into higher profits. Thus, when it comes time to negotiate for programming, cable operators have in recent years sought to persuade policymakers (and the public) that programmers are charging “too much,” and that consumers would be better off if they charged less.⁴

5. For example, the nation’s second largest cable operator, Time Warner Cable (“TWC”), recently has been in the news for its efforts to blame programmers for rising cable rates, no doubt because it has been engaged in a series of negotiations with key suppliers, including LIN-TV (which operates local broadcast stations) and Fox.⁵ Indeed, the public relations web site it created to influence public opinion during its year-end 2009 negotiations

2. Cable and broadcast rights are subject to different legal regimes. For a more complete explanation, *see* Jeffrey A. Eisenach, *The Economics of Retransmission Consent* (Washington, DC: Empiris LLC, March 2009).

3. The bundle of rights involved in these negotiations has grown increasingly complex over time. In addition to the basic right to carry video programming in real time, MSOs also acquire rights to distribute programming through Video-on-Demand (VOD) services, rights to related broadband content (e.g., ESPN 3), and so forth. The ability to “multi-purpose” video content has added to its value to MSOs.

4. On occasion, policymakers have even sought to turn public officials into unwitting pawns in their negotiating strategies. In 2003, for example, Cox Cable was highly supportive of Sen. John McCain’s efforts to impose “*a la carte*” regulation on programming networks, a position strongly opposed by the Walt Disney Company, with which Cox was then engaged in programming negotiations. Once an agreement was reached, Cox immediately dropped its support of Senator McCain’s initiative, admitting openly in testimony before Sen. McCain that its support for his legislation was simply a negotiating ploy designed to “to get the attention of the Walt Disney Company.” *See e.g.*, Jeffrey A. Eisenach and Douglas A. Trueheart, *Retransmission Consent and Cable Television Prices* (CapAnalysis LLC, March 2005) at 23; and *Hearing of the Senate Commerce, Science, and Transportation Committee*, “Escalating Cable Rates: Causes and Potential Solutions,” *Federal News Service* (March 25, 2004), at 32-33.

5. *See, e.g.*, Shira Ovide and Sam Schechner, “Time Warner Cable Fights Program Costs,” *The Wall Street Journal* (November 25, 2009).

with Fox claimed specifically that programming costs might cause cable rates to “increase significantly.”⁶

6. How is one to judge such claims? That is, how is one to judge whether the license fees programmers charge cable companies are “too high” or, alternatively, “too low”? From an economic perspective, the answer is straightforward: prices set in competitive markets maximize both economic efficiency and consumer welfare by equating the *cost* of producing the last unit of the product to the *value* consumers place on that same unit. Thus, in the absence of some sort of market failure (for example, if programmers had monopoly power that allowed them to charge higher-than-competitive prices), market prices in general are neither “too high” nor “too low,” but instead “just right.” Accordingly, the first thing economists look for in judging prices is the existence of market power or other forms of market failure. As I explain below, there is some evidence that cable operators may have market power vis-à-vis programmers – which might allow them to demand programming prices *below* market rates – but there is virtually no evidence of market power on behalf of programmers. Thus, cable operators’ claims that programming prices are “too high” do not square with the underlying structure of the marketplace.

7. Another way of approaching the question is to examine the role licensing fees play in the economics of MSOs, including changes over time. For example, how much do cable operators spend on programming relative to other costs, and how do programming costs compare

6. See <http://rolloverorgettough.com/faqs> (“[I]f we meet the demands requested by these networks, [rates] will increase significantly.”) (viewed December 28, 2009). Inevitably, the MSOs change their tune once negotiations are completed. A few days after TWC reached an agreement with Fox, its web page had been updated to acknowledge that it was “able to reach fair agreements with the TV networks” and to state explicitly that the Fox deal was not responsible for its recent price increases. (“Q: I just received a price increase from TWC. Is this the result of the negotiations? A: No. Programming costs are the largest factor in the price of TV service, but we have not yet determined how our new programming deals will affect prices.”) See <http://rolloverorgettough.com/faqs> (viewed January 7, 2010).

with other financial metrics, such as MSO profits? And, on the programming side, what is happening to the costs incurred by programmers to produce content in the first place – that is, to the extent licensing fees have increased in the aggregate, to what extent do they reflect (for example) changes in programmers’ underlying costs? As I explain below, it is clear on the basis of these common-sense financial metrics that cable operators’ claims are unjustified: Programming costs are not rising relative to cable operators’ revenues, profits, or other costs.

8. Moreover, to the extent license fees have risen in the aggregate, the increases are largely a reflection three factors. First, MSOs are purchasing more programming, and the programming they are purchasing is of higher quality. Second, programmers themselves are facing increased costs. Third, the value of programming content to cable operators as a driver of new business – as measured, for example, by the rising number of broadband and wireline telephony customers cable operators now serve – is increasing substantially.

9. The remainder of this paper is organized as follows. In Section II, I examine a variety of financial metrics relating to both programmers and distributors, and demonstrate that MSOs’ programming costs are falling relative to their revenues, costs, and profits. Thus, programming costs cannot properly be blamed for driving increases in the prices of cable TV services. In Section III, I discuss two important contextual factors affecting the value of video programming: The rising value of content to cable operators associated with their provision of multiple services (i.e., broadband and telephone); and, the rising prices paid by programmers to produce video content. In Section IV, I describe the competitive structure of both the “upstream” side of the market (i.e. programmers) and the “downstream” side (i.e., cable operators, direct broadcast satellite companies, and other multi-channel video program distributors, or “MVPDs”), and demonstrate that the upstream side of the market is highly competitive while the downstream side is relatively concentrated. Programmers are thus not

capable of imposing excessive prices or unfair terms on cable operators. Section V provides a brief summary of my conclusions.

II. PROGRAMMING COSTS ARE NOT RESPONSIBLE FOR CABLE PRICE INCREASES

10. Generally speaking, monthly subscription prices for cable television have increased more rapidly than inflation in recent years,⁷ a fact that has led to criticism by some public officials.⁸ One of the responses offered by major cable operators, including TWC, has been that increasing cable rates are caused by rising licensing fees for programming.⁹ As I demonstrate in this section, the data do not support this claim.

11. If programming costs are in fact driving cable price increases, we would expect to see them rising faster than cable company revenues, faster than other components of cable company costs, and faster than cable company profits. Instead, the opposite is true: programming costs are declining relative to relevant MSO financial metrics.

A. Programming Costs Have Decreased Relative to Other Costs

12. If increases in cable rates were explained by rising programming costs, then one would expect to see programming expenses accounting for an increasing share of overall MSO cost structures. In fact, the data suggest that the opposite is true. Programming costs are declining as a share of cable operators' cost structures.

7. *Thirteenth Annual MVPD Report* at ¶4 (“While competition in the delivery of video programming services has provided consumers with increased choice, better picture quality, and greater technological innovation, prices continue to outpace the general level of inflation.”).

8. See, e.g., Federal Communications Commission, *Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, MM Docket No. 92-266, Separate Statement of Chairman Kevin J. Martin (released December 27, 2006).

9. As noted above, such complaints tend to occur during negotiations for programming rights. Ironically, cable operators have also defended rising prices by arguing that they are justified because programming is becoming a better value for consumers. See, e.g., *In the Matter of Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming*, MB Docket No. 07-269, *Comments of the National Cable and Telecommunications Association* (May 20, 2009) at 24 (available at <http://www.ncta.com/PublicationType/RegulatoryFiling/NCTA-Comments-05-20-09.aspx>) (citing “a huge increase in output in terms of the number of channels, the quality and quantity of programming, etc.”).

13. To examine the role of programming costs, I gathered data on five publicly traded cable operators (Adelphia, Charter, Comcast, Knology, and TWC) for which up-to-date programming cost data are consistently available,¹⁰ as reported in Forms 10-K for the years 2003 through 2008.¹¹

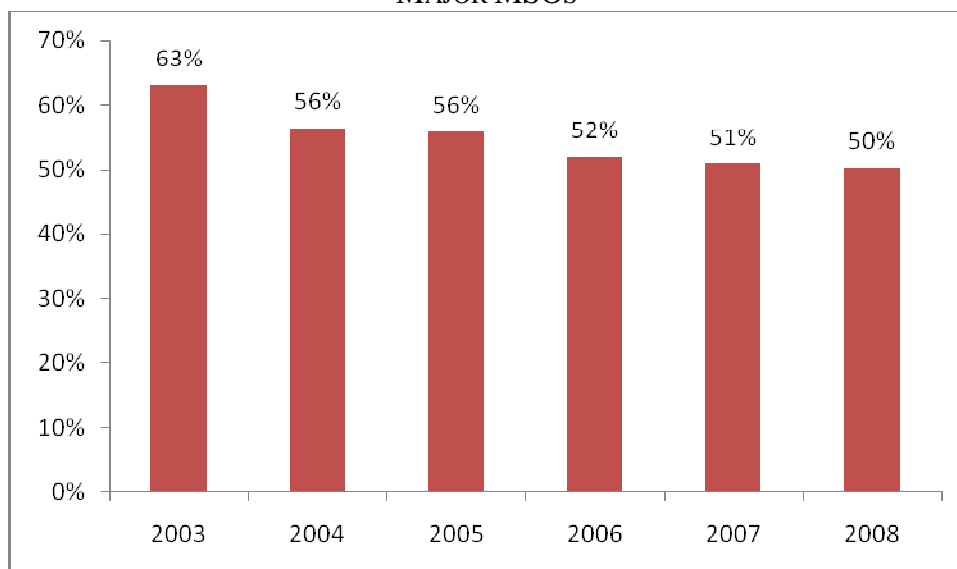
14. I calculated the share of costs accounted for by programming costs, taking weighted averages across companies. As seen in Figures 1 and 2 below, over the past five years, programming costs have fallen relative to either the cost of revenue or the sum of the cost of revenue and selling, general, and administrative expenses (“SG&A”).¹²

10. Data for Adelphia are available for the years leading up to the acquisition of its systems by Comcast and Time Warner (from 2003-2005). Therefore, the industry statistics given below include Adelphia for these years.

11. In some isolated cases, data from earlier years not available in Forms 10-K were supplemented with data derived from analyst reports by SNL Kagan and Morgan Stanley. *See* SNL Kagan, “Benchmarking Cable MSO Financial Statistics,” 2007 Edition; SNL Kagan, “Media Trends,” 2008 Edition; Morgan Stanley, “Cable Satellite Industry Overview: What Does the Market Expect?” (April 2004); Morgan Stanley, “Cable Satellite Industry Overview: Bundling and the Battle for Basic,” (October 2004).

12. I utilized these two cost categories to ensure comparability across companies. For example, Comcast provides cost of revenue and SG&A data for its cable segment, but does not provide segmented data on depreciation, amortization, or other cost categories. In addition, other cost categories often do not reflect the relevant underlying economics. For example, in 2008, TWC incurred a non-cash impairment of \$14.822 billion to reduce the carrying value of its cable franchise rights as a result of its annual impairment testing of goodwill and indefinite-lived intangible assets. If I had included this cost category in my calculations, the share of TWC’s costs accounted for by programming costs would have dipped artificially at the end of the sample period.

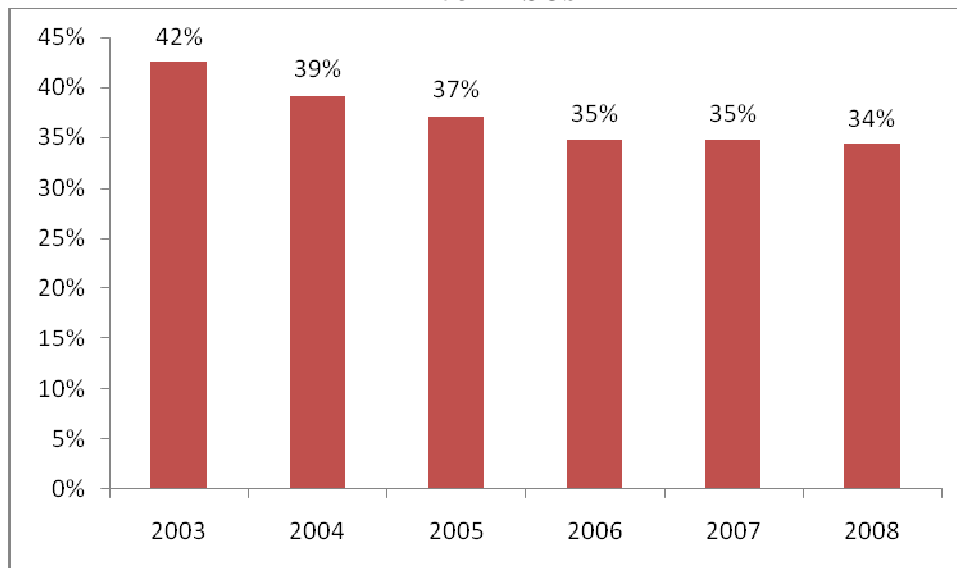
FIGURE 1:
PROGRAMMING COSTS AS A SHARE OF COST OF REVENUE,
MAJOR MSOs



Source: Cable operator 10-Ks; industry reports; Navigant Economics LLC calculations.

15. For these five major MSOs, the share of cost of revenue accounted for by programming costs declined from 63 percent to 50 percent between 2003 and 2008; during the same period, the share of cost of revenue plus SG&A accounted for by programming costs shrank from 42 percent in 2003 to 34 percent in 2008.

FIGURE 2:
PROGRAMMING COSTS AS A SHARE OF COST OF REVENUE + SG&A,
MAJOR MSOs



Source: Cable operator 10-Ks; industry reports; Navigant Economics LLC calculations.

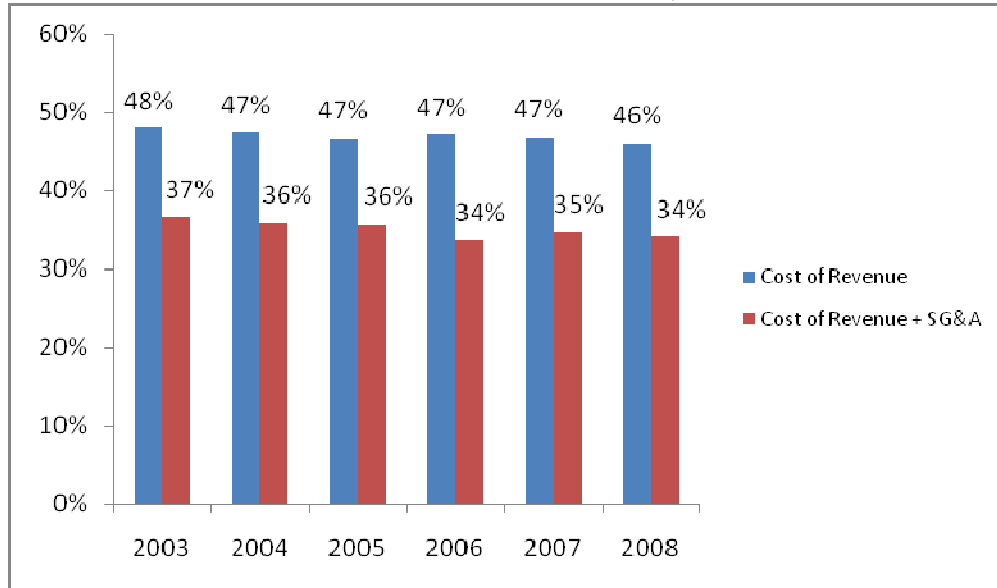
16. Because TWC recently has taken a particularly aggressive public stance on these issues, I also examined data on TWC over this same time period. As a result of TWC's acquisition of Adelphia assets, I combined data for Adelphia with data for TWC for the years 2003 – 2005 to arrive at pro-forma estimates for a hypothetical consolidated entity ("TWC Pro-Forma") that would have existed prior to 2006. Thus, the financial data for TWC Pro-Forma reflect TWC financials from 2006 forward, and a consolidation of TWC and Adelphia financials from 2003 – 2005.¹³

17. I then calculated the share of costs accounted for by programming costs for TWC Pro-Forma. As shown in Figure 3 below, programming costs have fallen relative to both the cost

13. According to Forms 10-K for Comcast and TWC for the 2006 fiscal year, the two companies gained 1.7M and 3.2M net subscribers respectively as a result of (1) their joint acquisition of Adelphia assets; and (2) swaps of cable systems between Comcast and TWC. I therefore estimated that TWC acquired approximately 65 percent of Adelphia's subscribers (equal to $3.2/(1.7+3.2)$). Therefore, for the years 2003 – 2005, I allocated 65 percent of Adelphia's subscribers, revenues, and costs to TWC Pro-Forma. See Time Warner Cable, Form 10-K, filed Feb. 23, 2007. See also Comcast Corporation, Form 10-K, filed Feb. 26, 2007.

of revenue and the sum of the cost of revenue and SG&A. Programming costs accounted for 48 percent of the cost of revenue in 2003, and 46 percent in 2008. Similarly, programming costs made up 37 percent of the sum of cost of revenue and SG&A in 2003, but only 34 percent in 2008.

FIGURE 3:
PROGRAMMING COSTS AS A SHARE OF COSTS, TWC PRO-FORMA



Source: TWC and Adelphia 10-Ks; industry reports; Navigant Economics LLC calculations.

B. Programming Costs Have Decreased Relative to Revenues

18. If increases in cable rates were explained by rising programming costs, then one would expect to see programming expenses increasing relative to cable revenues. This is true for two reasons. First, cable operators would be unlikely to pass 100 percent of an increase in programming costs on to consumers, at least in the short run.¹⁴ Therefore, holding other factors constant, programming costs would be expected to rise more than revenues. Second, holding other factors constant, any cost increase that cable operators did pass through would cause

14. Only firms in perfectly competitive industries pass on 100 percent of an increase in marginal cost to end users. As I explain further in Section IV below, the cable business is not perfectly competitive.

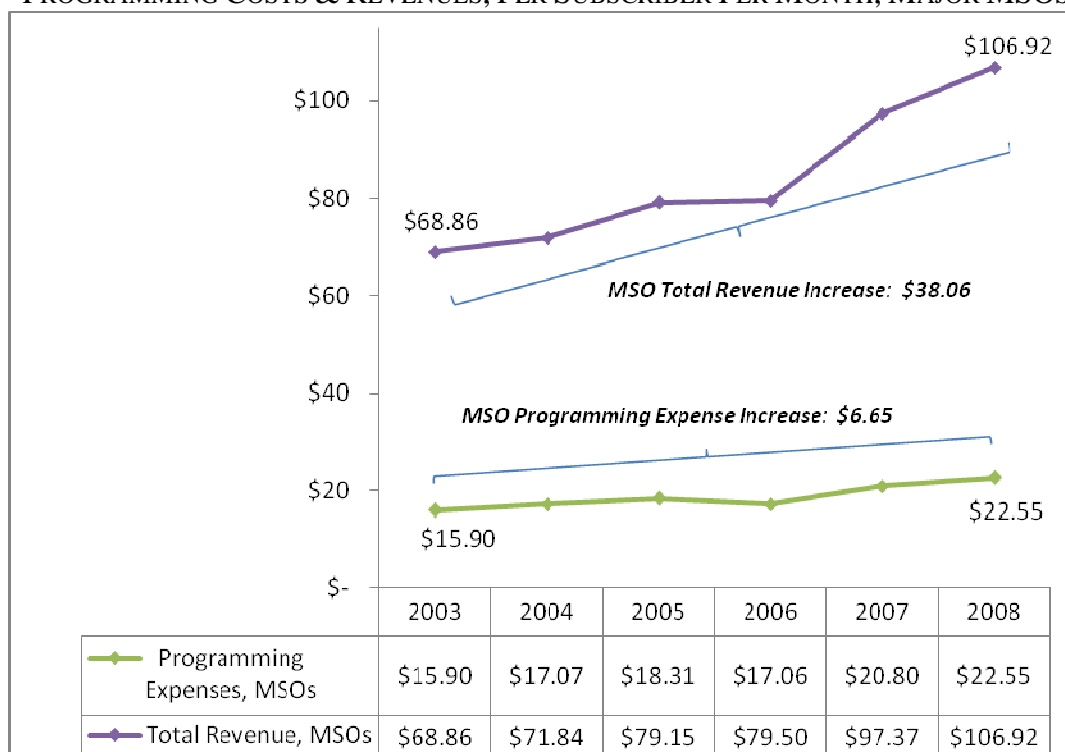
consumers to reduce their purchases of cable television services. This would cause revenues to fall, both in absolute terms and relative to programming costs.¹⁵ As I show below, the best available evidence suggests the opposite: cable revenues are rising relative to programming costs, and in some cases, significantly so.

19. As above, I examined data on the five publicly traded MSOs for which up-to-date programming cost data are consistently available. I calculated the rate of increase of these companies' programming expenses and their total revenues per subscriber per month, again taking weighted averages across companies, for the period 2003 through 2008. Although programming expenses for the MSOs increased by approximately 42 percent (from \$15.90/sub/month to \$22.55/sub/month), total revenues increased by approximately 55 percent (from \$68.86/sub/month to \$106.92/sub/month). Thus, the available evidence indicates that cable programming expenses are, if anything, decreasing relative to total revenues.

20. The relative increases can also be compared in absolute terms. As shown in Figure 4, monthly revenues per subscriber per month rose by \$38.06 per month between 2003 and 2008, while programming expenses rose by only \$6.65. Put differently, for every dollar increase in programming expenses, MSOs raised total charges to consumers by \$5.72.

15. Past research has found the demand for cable to be elastic, which implies that a price increase causes total revenues to fall. See *Federal Communications Commission, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, MM Docket No. 92-266 (Feb. 14, 2001) at ¶48 (estimating the own-price elasticity of demand for cable television at -1.95).

FIGURE 4:
PROGRAMMING COSTS & REVENUES, PER SUBSCRIBER PER MONTH, MAJOR MSOs



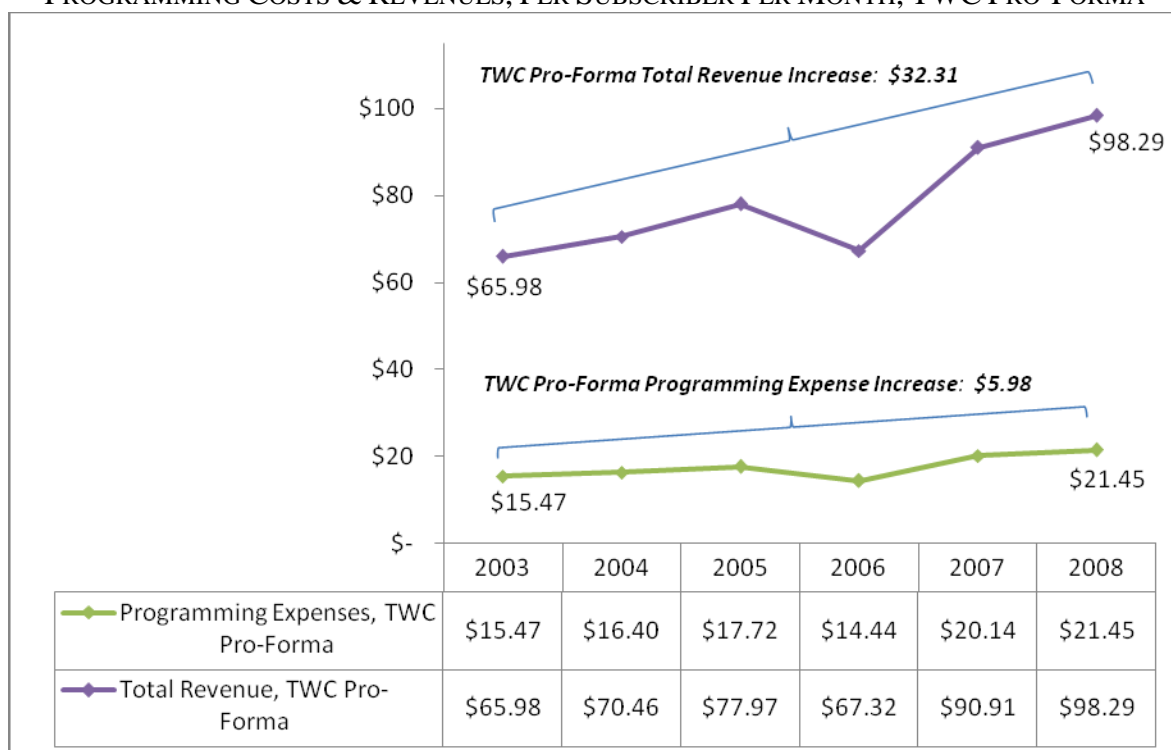
Source: Cable operator 10-Ks; industry reports; Navigant Economics LLC calculations.

21. I also examined data for TWC over this same time period. As before, I combined data for Adelphia with data for TWC for the years 2003 through 2005 to arrive at estimates for TWC Pro-Forma, allocating approximately two thirds of Adelphia's revenues, costs, and subscribers to TWC Pro-Forma in these years.

22. I then calculated the rate of increase of programming expenses and total revenues per subscriber per month for TWC Pro-Forma, from 2003 through 2008. As shown in Figure 5, although programming expenses for TWC Pro-Forma increased by approximately 39 percent from 2003 to 2008 (from \$15.47/sub/month to \$21.45/sub/month), total revenues increased by approximately 49 percent over this same period (from \$65.98/sub/month to \$98.29/sub/month). Thus, the available evidence indicates that programming expenses have decreased relative to revenues for TWC Pro-Forma.

23. In absolute terms, for every dollar increase in programming costs TWC incurred during this period, it raised total charges to consumers by \$5.40 (\$32.31/\$5.98).

FIGURE 5:
PROGRAMMING COSTS & REVENUES, PER SUBSCRIBER PER MONTH, TWC PRO-FORMA



Source: TWC and Adelphia 10-Ks; industry reports; Navigant Economics LLC calculations.

C. Programming Costs Have Decreased Relative to Profits

24. I also compared the growth in programming costs over time to the increase in per-subscriber profitability that MSOs have enjoyed in recent years. If programming cost increases were a significant factor forcing cable operators to raise rates, other things equal, one would expect that profits would decline as programming expenses increased.¹⁶ Instead, the data suggest that profitability has increased over time, both in absolute terms and relative to programming

16. As noted above, only perfectly competitive firms pass along 100 percent of price increases.

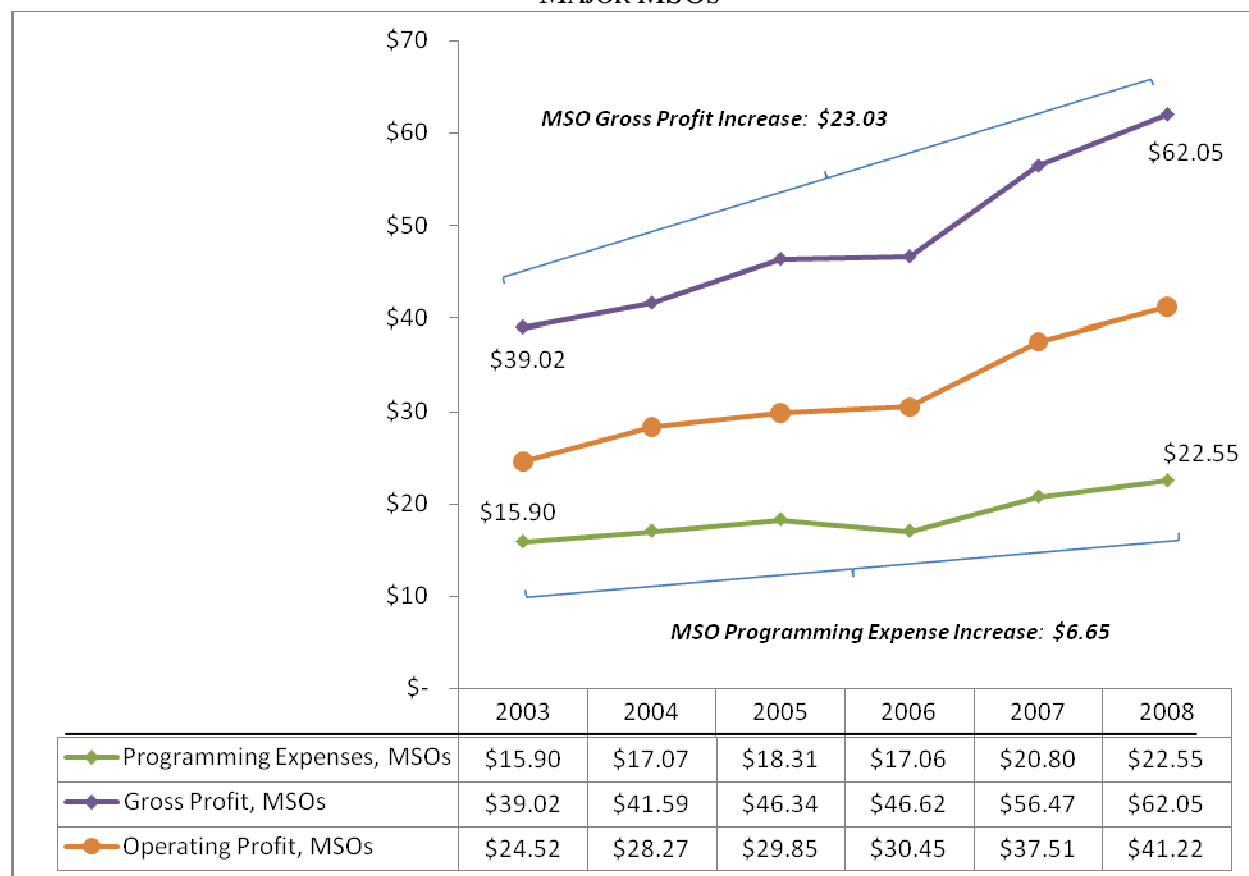
costs. This result is hardly surprising, given that programming costs have declined relative to both costs and revenues, as documented above.

25. As above, I examined data on the publicly traded MSOs for which up-to-date programming cost data are consistently available. I calculated the rate of increase of these companies' programming expenses and two profitability metrics, gross profit per subscriber and operating profit per subscriber, from 2003 - 2008.¹⁷

26. As shown in Figure 6, although programming expenses for the MSOs increased by approximately 42 percent (from \$15.90/sub/month to \$22.55/sub/month), MSO gross profits increased by approximately 59 percent (from \$39.02/sub/month to \$62.05/sub/month). Operating profits for the MSOs increased by approximately 68 percent over this same interval (from \$24.52/sub/month to \$41.22/sub/month). Thus, the available evidence suggests that profitability has increased substantially relative to programming costs for MSOs – exactly the opposite of what should have transpired if programming expenses had forced MSOs to raise cable prices.

17. Gross profit is computed as total revenues net of total costs of revenue. Operating profit is computed as total revenues net of total costs of revenue and SG&A. As noted above, the use of SG&A ensures comparability across companies, and eliminates cost categories that do not reflect the relevant underlying economics.

FIGURE 6:
PROGRAMMING COSTS & PROFITABILITY METRICS, PER SUBSCRIBER PER MONTH,
MAJOR MSOs



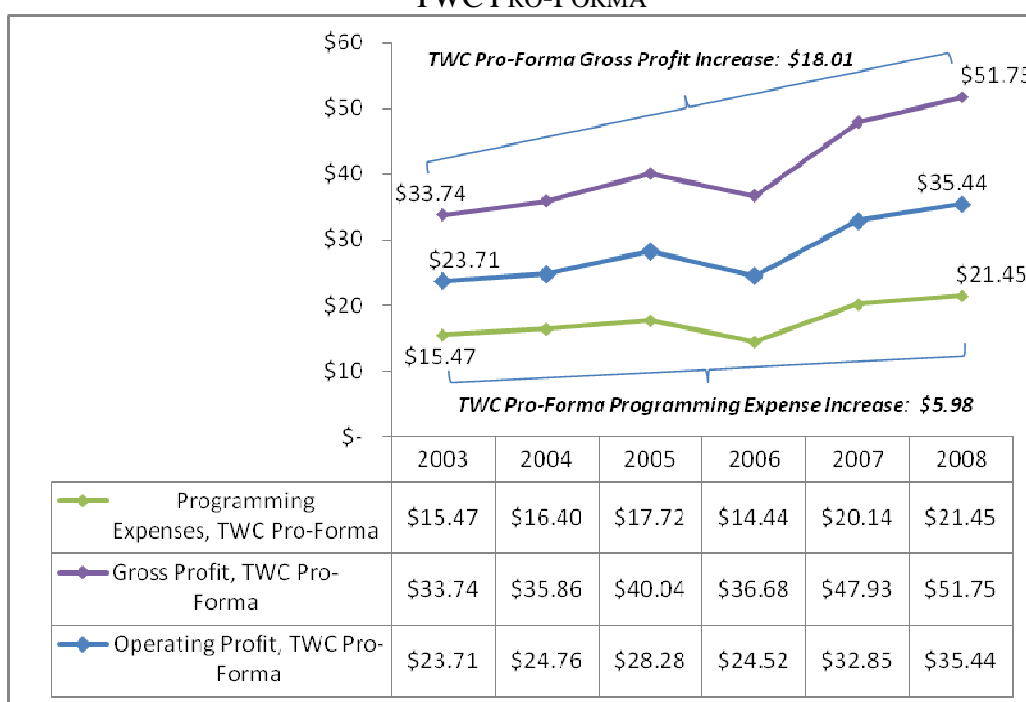
Source: Cable operator 10-Ks; industry reports; Navigant Economics LLC calculations.

27. As with the other metrics examined above, I also examined profitability metrics for TWC over this same time period. As before, I combined data for Adelphia with data for TWC for the years 2003 – 2005 to arrive at estimates for TWC Pro-Forma.

28. I then calculated the rates of increase of gross profit and operating profit per subscriber per month for TWC Pro-Forma, and compared them to increases in TWC Pro-Forma's operating costs. As shown in Figure 7, although programming expenses for TWC Pro-Forma increased by approximately 39 percent from 2003 to 2008 (from \$15.47/sub/month to \$21.45/sub/month), gross profits increased by approximately 53 percent over this same interval (from \$33.74/sub/month to \$51.75/sub/month). Moreover, operating profits increased by

approximately 49 percent (from \$23.71/sub/month to \$35.44/sub/month). Thus, the available evidence suggests that TWC Pro-Forma's profitability has increased substantially in recent years, both in absolute terms and relative to programming expenses. In absolute terms, for every dollar increase in programming expenditures TWC incurred over this period, its gross profits rose by \$3.01 (\$18.01/\$5.98).

FIGURE 7:
PROGRAMMING COSTS & PROFITABILITY METRICS, PER SUBSCRIBER PER MONTH,
TWC PRO-FORMA



Source: TWC and Adelphia 10-Ks; industry reports; Navigant Economics LLC calculations.

III. THE CHANGING MARKET FOR VIDEO PROGRAMMING

29. In recent years, the value of video programming to cable operators has increased. In part, as noted above, this is simply a function of the fact that MSOs are purchasing more programming, and higher quality programming, which is valued by consumers.¹⁸ In addition, MSOs have benefited from their ability to use video services to draw subscribers to other product offerings, such as wireline telephony and high-speed internet. MSOs are increasingly relying on bundles of services offered through their networks to increase average revenues per customer. By offering multiple services over the same network, cable operators can defray their fixed costs over a broader revenue base and boost profitability. Thus, bundling increases the value of video programming, because the potential for marketing wireline telephony and high-speed data increases the expected profitability of attracting additional video subscribers to the network. At the same time as the value of programming to MSOs has been rising, the costs of producing high-quality programming have also risen.

A. The Value of Programming to MSOs is Increasing

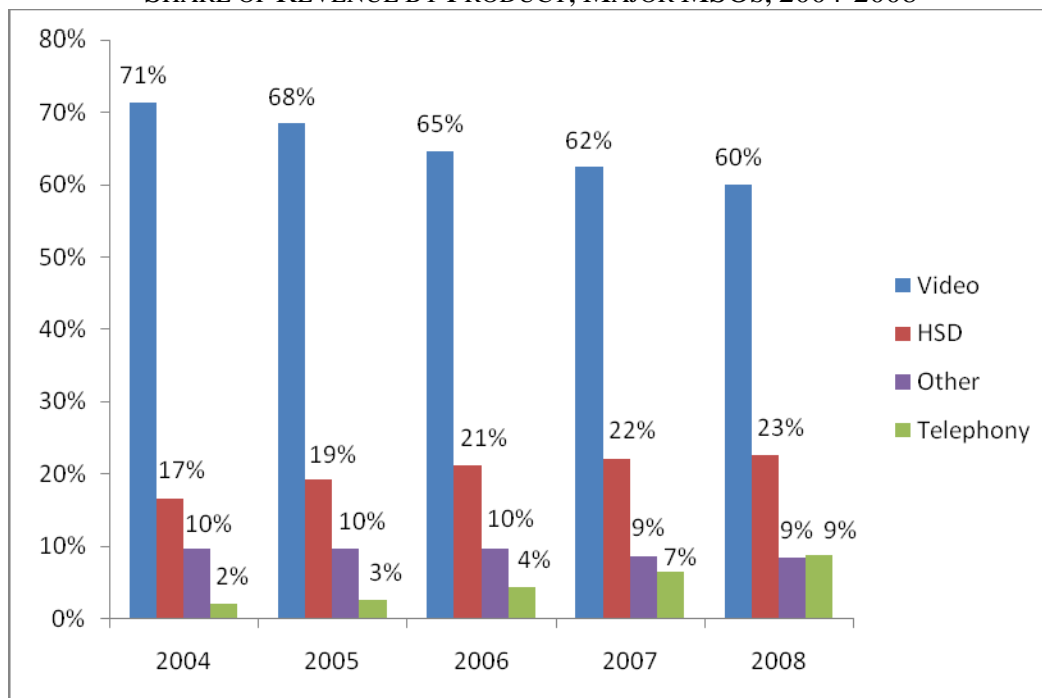
30. Virtually all major cable operators and local telephone companies now compete in the marketplace as multi-product firms. Comcast, Cox, Mediacom, TWC, AT&T and Verizon, for example, all offer broadband and wireline telephony services in addition to video programming, often marketed to consumers in “double-play” and “triple-play” bundles. In addition to its value as a stand-alone product, video programming is an essential input into these multi-product lineups, as consumers who subscribe to a given video provider on the basis of its programming offerings are more likely to subscribe to one or more bundled services as well.

31. While video programming still accounts for the majority of major MSOs’ revenue, the share of overall revenue attributable to broadband and telephony services is growing

18. The MSOs acknowledge as much; see n. 9 above.

rapidly, as shown in Figure 8. For example, Comcast's revenue from high-speed data services has more than doubled over the past four years, increasing from \$2.9 billion in 2004 to \$7.2 billion in 2008.¹⁹ Over the same period, Comcast's revenue from residential telephony more than quadrupled, from \$620 million to over \$2.6 billion.²⁰

FIGURE 8:
SHARE OF REVENUE BY PRODUCT, MAJOR MSOs, 2004-2008



Source: Cable operator 10-Ks; industry reports; Navigant Economics LLC calculations.

32. Like other major MVPDs, Time Warner Cable derives an increasing share of its total revenue from HSD and telephony. TWC's revenue from HSD increased from \$1.6 billion in 2004 to \$4.2 billion in 2008, an increase of over 150 percent over four years.²¹ Similarly, TWC's revenue from telephony services increased from \$29 million in 2004 to \$1.6 billion in 2008.²²

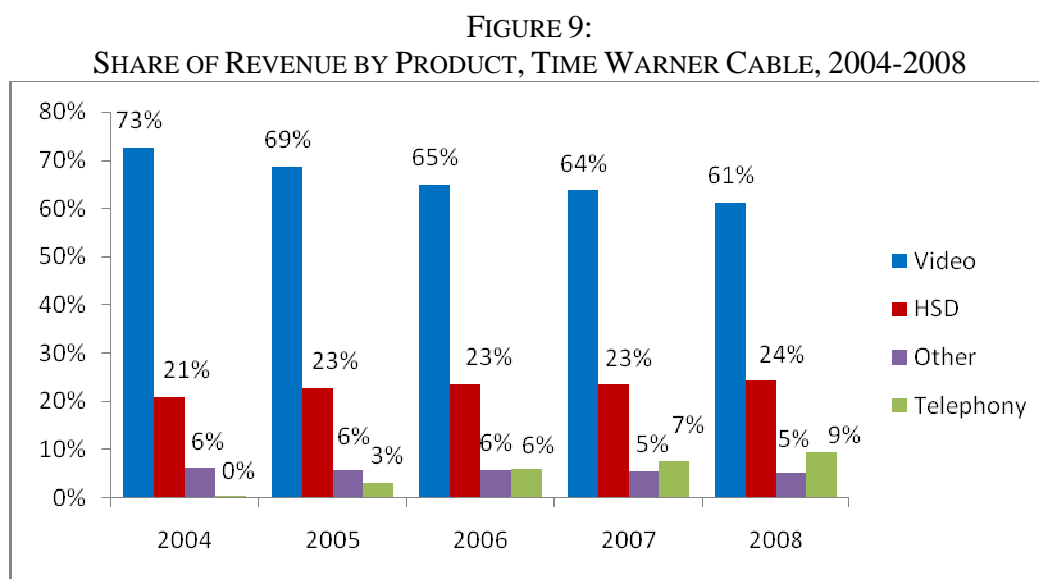
19. For 2008 figure, *see* Comcast Corporation, Form 10-K, filed Feb. 20, 2009. For 2004 figure, *see* Comcast Corporation, Form 10-K, filed Feb. 26, 2007.

20. *Id.*

21. For 2008 figure, *see* Time Warner Cable, Form 10-K, filed Feb. 20, 2009. For 2004 figure, *see* Time Warner Cable, Form 10-K, filed Feb. 23, 2007.

22. *Id.*

Figure 9 illustrates the growth in revenue for TWC attributable to HSD and telephony services over time.



Source: Time Warner Cable 10-Ks; Navigant Economics LLC calculations.

33. Time Warner Cable has made marketing double- and triple-play services a focus of its business strategy,²³ including developing services that are available only to customers who purchase multiple products, including advanced caller ID and the ability share photos via video-on-demand service.²⁴ Table 1 shows the percentage of TWC customers who purchase services as part of a double or triple-play bundle.

23. Time Warner Cable Inc., Form 10-K, filed Feb. 20, 2009, at 9 (“In addition to selling its services separately, TWC is focused on marketing differentiated packages of multiple services and features, or ‘bundles’ for a single price. TWC offers bundled services to both its residential and commercial customers and, increasingly, these customers subscribe to two or three of TWC’s primary services. TWC customers who subscribe to a bundle receive a discount from the price of buying the services separately as well as the convenience of a single monthly bill.”).

24. *Id* at 9-10.

TABLE 1:
TIME WARNER CABLE, DOUBLE AND TRIPLE-PLAY SUBSCRIBERS, 2006-2008

	2006	2007	2008
Total Subscribers (000's)	14,565	14,626	14,582
Double-play Customers (000's)	4,647	4,703	4,794
Double-play %	31.9%	32.2%	32.9%
Triple-play Customers (000's)	1,523	2,363	3,099
Triple-play %	10.5%	16.2%	21.3%

Source: Time Warner Cable Inc., Form 10-K, filed February 20, 2009, at 10.

34. As shown in Table 1, by 2008, more than half of TWC's customers subscribed to two or more services, and virtually all of them subscribed to video. For example, over 80 percent of TWC's residential telephony subscribers were triple-play subscribers.²⁵

B. Programmers' Costs Have Increased In Response to the Competitive Landscape

35. Economists and regulators alike have observed that the content aired by national programming networks has improved in both quality and variety in recent years.²⁶ Consumers can choose between more shows, news, and specialized programming than ever before, and can often view desired programs in High Definition formats. Sports enthusiasts, for example, can watch a greater number of games and associated pre and post-event coverage than in years past, from more leagues in the United States and abroad, and from college and high school ranks. The flip side of this increase in the quality and scope of programming, however, is that the costs incurred by networks to produce original content and to secure the rights to sporting and other events have increased as well.²⁷

25. *Id.* at 7-10; Navigant Economics LLC calculations.

26. Cable operators agree. *See* n. 9 above.

27. SNL Kagan, "The Economics of Basic Cable Networks," 2008 Edition, at 15 ("There has been a slight acceleration in the last two years as there has been a shift to more original programming, with programming [costs] as a percentage of revenue rising from the 44%-45% range during 2001-2005 to the 46-47% range in 2006 and 2007.").

IV. MARKET STRUCTURE AND COMPETITION IN THE MARKET FOR VIDEO PROGRAMMING

36. License fees for video programming are set in bilateral negotiations between content creators and content distributors (referred to hereafter as multichannel video programming distributors, (“MVPDs”), which includes MSOs, satellite platforms, and local exchange carriers that provide video services). As the discussion below demonstrates, there are far more programming networks than MVPDs, and concentration, properly measured, is much higher among MVPDs than programmers. Moreover, cable operators increasingly have grouped their operations into local “clusters” of systems, which, as explained further below, gives them significant market power in negotiating for local content, such as retransmission rights for broadcast stations or program rights for regional cable networks.

37. As of 2008, nearly three quarters of all MVPD subscribers received video programming from one of only four major multi-channel video distributors, cable companies Comcast and Time Warner Cable, and satellite providers DIRECTV and EchoStar.²⁸ On the other hand, the market for programming is highly fragmented, with more than 500 different national programming networks, dozens of additional regional networks, and over 1,700 local broadcast TV stations.

A. The Upstream Market is Highly Competitive

38. The upstream side of the video programming market is highly competitive. The more than 565 programming networks are owned by a large number of different firms, and no single company controls networks that account for more than about 16 percent of the market. Moreover, the market has experienced, and continues to experience, substantial entry, including entry (and exit) by MSOs, which can and do own and operate their own programming networks.

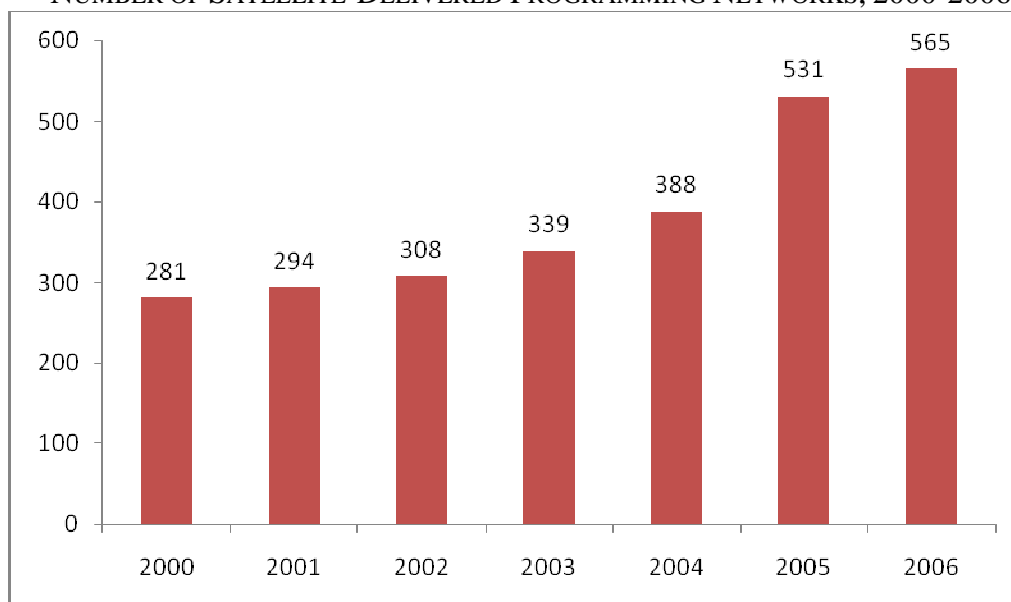
28. SNL Kagan, “Broadband Cable Financial Databook,” 2009 Edition.

In such a market, there is simply no basis for believing programmers have the ability to charge higher-than-competitive prices.

39. The FCC reports that, in 2006, there were 565 satellite-delivered national programming networks, an increase of 34 networks over the 2005 total of 531 networks.²⁹ This rapid entry – a six percent increase in the number of national networks in the course of just one year – indicates that barriers to entry in the marketplace are low, and incumbent programmers are under constant threat of competition from new as well as existing networks. As shown in Figure 10, the number of satellite-delivered networks has grown consistently in recent years.

29. *Thirteenth Annual MVPD Report* at ¶186.

FIGURE 10:
NUMBER OF SATELLITE-DELIVERED PROGRAMMING NETWORKS, 2000-2006



Source: *Thirteenth Annual MVPD Report* at ¶20; Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Twelfth Annual Report, MB Docket No. 05-255 (Mar. 3, 2006), at ¶157; Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Eleventh Annual Report, MB Docket No. 04-227 (Feb. 4, 2005), at ¶145; Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Tenth Annual Report, MB Docket No. 03-172 (Jan. 28, 2004), at ¶17; Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Ninth Annual Report, MB Docket No. 02-145 (Dec. 31, 2002), at ¶13; Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Eighth Annual Report, CS Docket No. 01-129 (Jan. 14, 2002), at ¶13. Note: 2004 and prior years are not strictly comparable to 2005-6.

40. The competitiveness of the programming market has also been affected by the rapid increase in programming choices and accompanying audience fragmentation. As shown in Figure 11, for example, the highest-rated television show in 1950 (Texaco's "Star Theater") captured over 60 percent of the prime-time audience; as recently as the 1980s it was typical for top-rated shows to capture ratings in the 30s. By the turn of the century, however, the top-rated show had fallen to less than a 20 percent rating, and the decline is continuing.

FIGURE 11:
DECLINE IN AUDIENCE SHARES OF MOST POPULAR PROGRAMS

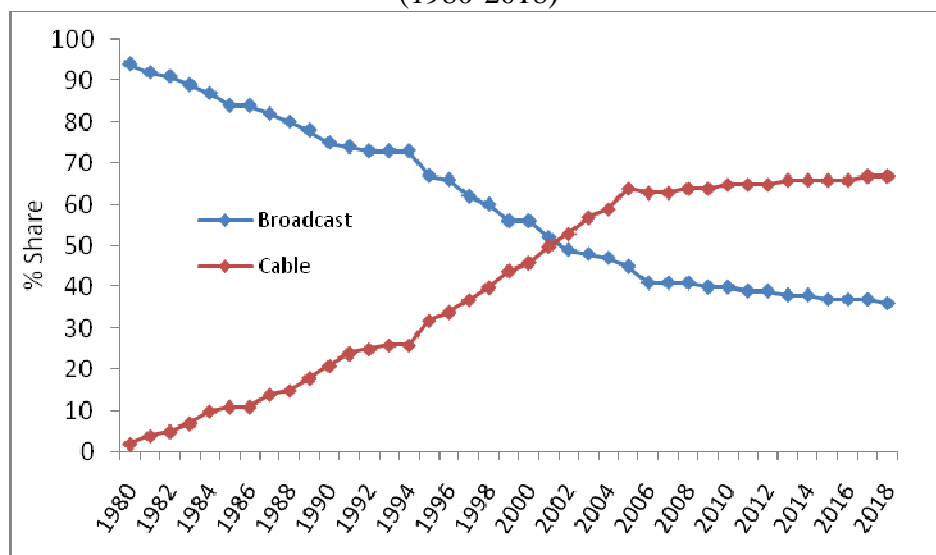
Highest-Rated TV Shows of Each Season (1950-2005)					
Season	Program	Rating	Season	Program	Rating
1950-51	<i>Texaco Star Theater</i>	61.6	1978-79	<i>Laverne & Shirley</i>	30.5
1951-52	<i>Godfrey's Talent Scouts</i>	53.8	1979-80	<i>60 Minutes</i>	28.2
1952-53	<i>I Love Lucy</i>	67.3	1980-81	<i>Dallas</i>	31.2
1953-54	<i>I Love Lucy</i>	58.8	1981-82	<i>Dallas</i>	28.4
1954-55	<i>I Love Lucy</i>	49.3	1982-83	<i>60 Minutes</i>	25.5
1955-56	<i>\$64,000 Question</i>	47.5	1983-84	<i>Dallas</i>	25.7
1956-57	<i>I Love Lucy</i>	43.7	1984-85	<i>Dynasty</i>	25
1957-58	<i>Gunsmoke</i>	43.1	1985-86	<i>Cosby Show</i>	33.8
1958-59	<i>Gunsmoke</i>	39.6	1986-87	<i>Cosby Show</i>	34.9
1959-60	<i>Gunsmoke</i>	40.3	1987-88	<i>Cosby Show</i>	27.8
1960-61	<i>Gunsmoke</i>	37.3	1988-89	<i>Roseanne</i>	25.5
1961-62	<i>Wagon Trail</i>	32.1	1989-90	<i>Roseanne</i>	23.4
1962-63	<i>Beverly Hillbillies</i>	36.0	1990-91	<i>Cheers</i>	21.6
1963-64	<i>Beverly Hillbillies</i>	39.1	1991-92	<i>60 Minutes</i>	21.7
1964-65	<i>Bonanza</i>	36.3	1992-93	<i>60 Minutes</i>	21.6
1965-66	<i>Bonanza</i>	31.8	1993-94	<i>Home Improvement</i>	21.9
1966-67	<i>Bonanza</i>	29.1	1994-95	<i>Seinfeld</i>	20.5
1967-68	<i>Andy Griffith</i>	27.6	1995-96	<i>E.R.</i>	22.0
1968-69	<i>Rowan & Martin's Laugh-In</i>	31.8	1996-97	<i>E.R.</i>	21.2
1969-70	<i>Rowan & Martin's Laugh-In</i>	26.3	1997-98	<i>Seinfeld</i>	22.0
1970-71	<i>Marcus Welby, MD</i>	29.6	1998-99	<i>E.R.</i>	17.8
1971-72	<i>All in the Family</i>	34.0	1999-00	<i>Who Wants to be a Millionaire</i>	18.6
1972-73	<i>All in the Family</i>	33.3	2000-01	<i>Survivor II</i>	17.4
1973-74	<i>All in the Family</i>	31.2	2001-02	<i>Friends</i>	15.3
1974-75	<i>All in the Family</i>	30.2	2002-03	<i>CSI</i>	16.1
1975-76	<i>All in the Family</i>	30.1	2003-04	<i>CSI</i>	15.9
1976-77	<i>Happy Days</i>	31.5	2004-05	<i>CSI</i>	16.3
1977-78	<i>Laverne & Shirley</i>	31.6	2005-06	<i>American Idol</i>	12.9
			2006-07	<i>American Idol</i>	12.3

Source: Nielsen Media Research

Source: Adam Thierer and Grant Eskelsen, *Media Metrics: The True State of the Modern Media Marketplace* (The Progress & Freedom Foundation, 2008) at 58, citing Nielsen Media Research.

41. Competition has affected every aspect of the programming business. As shown in Figure 12, cable networks have consistently taken share from broadcast networks, and are projected to continue taking share in the future.

FIGURE 12:
ACTUAL AND PROJECTED BROADCAST VS. BASIC CABLE VIEWING SHARES
(1980-2018)



Source: SNL Kagan, “Broadband Cable Financial Databook”, 2008 Edition.

42. As shown in Table 2, concentration of network ownership is low by traditional antitrust standards, and falling: The top six media “conglomerates” have combined prime-time audience shares of under 75 percent, and the Herfindahl-Hirschman Index (the most commonly used measure of industry concentration) is below 900 – that is, well within the range the Department of Justice considers “unconcentrated.”³⁰

30. See U.S. Department of Justice and U.S. Federal Trade Commission, *Horizontal Merger Guidelines* (1997) at 15-16.

TABLE 2:
PRIME TIME AUDIENCE SHARES (PERCENT) AND HERFINDAHL-HIRSCHMAN INDICES FOR THE SIX
LEADING MEDIA “CONGLOMERATES” (2000-2006)

	2000	2001	2002	2003	2004	2005	2006
Time Warner	14	13	14	13	12	11	11
News Corporation	8	9	8	12	10	10	10
NBC Universal	12	11	12	12	11	12	12
Disney	18	16	15	14	14	15	16
Viacom	5	6	7	6	7	8	8
CBS	15	16	15	14	13	14	14
Combined Share	72	71	71	71	67	70	71
HHI Index	978	919	903	885	779	850	881

Source: Share data from Nielsen Media Research and Wolzien LLC as reported in Michael Nathanson, et. al., *Big Thinking on Small Caps: As Primetime Content Distribution Expands, Will Local Broadcasters Go The Way of Your Local Record Store?* (Bernstein Research, January 17, 2007), at Exhibit 1.

43. Ownership of video programming content is diverse as well as unconcentrated. Of the 565 national networks identified by the FCC in 2006, only 84 (14.9 percent) were affiliated with a cable MSO,³¹ and only 124 (22 percent) were affiliated with a DBS provider or with a national broadcast television network. Put differently 357 of the 565 networks (63.2 percent) are unaffiliated with either a broadcast network or an MVPD.³²

44. While relatively few cable networks are owned by MSOs, it is also true that most of the top MSOs, including Comcast, Cox, Cablevision, Advance/Newhouse, and, until 2009, Time Warner, own cable programming networks.³³ From an economic perspective, the fact that cable operators like Comcast and Cox can and do compete directly with independent programmers like Disney and Viacom is an indicator that programmers do not have the ability to charge cable operators higher-than-competitive prices – since, if they attempted to do so, the cable operators could shift toward self-provisioning. Thus, MVPD ownership of programming

31. *Thirteenth Annual MVPD Report* at ¶20, and Appendix C, Table C-1. This figure includes the 30 networks wholly owned by Time Warner, which was then the parent company of Time Warner Cable.

32. *Id.*

33. *Id.* at ¶186.

networks would act as a constraint – if one were necessary – on the exercise of market power by programmers.³⁴

45. In this context, Time Warner Cable’s recent spin-off from parent Time Warner Inc., despite Time Warner Inc.’s ownership of several major programming networks (including CNN, TNT and the Cartoon Network),³⁵ is an indication that TWC does not believe programmers have market power. If TWC were truly concerned about the ability of programmers to charge excessive rates, it would presumably have resisted the spin-off in order to continue to avail itself of lower prices from its affiliated programming. Yet, at the time the transaction was announced, Time Warner President and CEO Jeff Bewkes stated unambiguously that, “After the transaction, each company will have greater strategic, financial and operational flexibility and will be better positioned to compete.”³⁶

B. The Downstream Market is Relatively Concentrated

46. In contrast to the upstream (sellers) market, the downstream (buyers) market for video programming is characterized by high levels of concentration among a few major MVPDs. As shown in Table 3, below, in 2008, the four MVPDs with the largest subscribership – Comcast, Time Warner Cable, DIRECTV, and EchoStar – served 71.2 percent of all MVPD subscribers. The top ten MVPDs serve 91 percent of subscribers.

34. Moreover, academic studies have shown that, other things equal, a cable operator is more likely to carry MVPD affiliated programming (regardless of whether it is affiliated with that cable operator or a different MVPD) than to carry other programming. *See, e.g.,* Tasneem Chitty, “Vertical Integration, Market Foreclosure, and Consumer Welfare in the Cable Television Industry,” *American Economic Review* 91 (2001) 428.

35. *See* note 33.

36. *See* Time Warner Cable, “Time Warner and Time Warner Cable Agree to Separation,” Press Release (May 21, 2008) (available at <http://files.shareholder.com/downloads/TWX/315037497x0x197385/344b58ac-cb91-4625-8ca9-c0c0dc886810/newrelease.pdf>). If programmers had significant market power over MVPDs, one would expect far more vertical integration than is observed, as firms sought to avoid the problem economists refer to as “double marginalization,” which occurs when an upstream firm charges higher-than-competitive prices to a downstream firm which also possesses market power. For a simple explanation of double marginalization, see [http://faculty.haas.berkeley.edu/rjmorgan/Double%20Marginalization%20v2.ppt#276,19,Other Issues](http://faculty.haas.berkeley.edu/rjmorgan/Double%20Marginalization%20v2.ppt#276,19,Other%20Issues).

TABLE 3:
MVPD MARKET SHARES (BY NUMBER OF SUBSCRIBERS), 2008

Rank	Company	Percentage of Subscribers
1	Comcast	25.1%
2	DIRECTV	18.3%
3	EchoStar	14.2%
4	Time Warner Cable	13.6%
Top 4		71.2%
5	Cox	5.5%
6	Charter	5.2%
7	Cablevision	3.2%
8	Bright House	2.4%
9	Verizon FIOS	2.0%
10	Mediacom	1.4%
Top 10		91.0%

Source: SNL Kagan, “Broadband Cable Financial Databook,” 2009 Edition;
Navigant Economics LLC calculations.

47. In addition to these relatively high levels of concentration at the national level, and as the FCC has noted, MSOs have also recently significantly increased the level of concentration at the local level by pursuing a regional strategy of “clustering.”³⁷ According to SNL Kagan, the number of clustered cable systems (cable systems under the same ownership serving the same local market area or region) serving over 500,000 subscribers rose from 29 in 2005, covering 29.8 million subscribers, to 36 at the end of 2008, covering 36.7 million subscribers.³⁸

48. TWC has been one of the most successful MSOs when it comes to clustering. As the company’s 2009 10-K report says, TWC “is the second-largest cable operator in the U.S., with technologically advanced, *well-clustered systems* located mainly in five geographic areas –

37. Clustering refers to the practice by which two MSOs agree to “swap” cable systems in different geographic areas where the other already has a significant presence, thus concentrating their operations into specific regions where all or nearly all households receive service from the same MSO. See *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Eleventh Annual Report, MB Docket No.04-227 (Feb. 4, 2005) at ¶141 (“Cable operators continue to pursue a regional strategy of ‘clustering’ their systems. Many of the largest MSOs have concentrated their operations by acquiring cable systems in regions where the MSO already has a significant presence, while giving up other holdings scattered across the country. This strategy is accomplished through purchases and sales of cable systems, or by system ‘swapping’ among MSOs.”).

38. SNL Kagan, “Broadband Cable Financial Yearbook,” 2009 Edition.

New York State (including New York City), the Carolinas, Ohio, southern California (including Los Angeles) and Texas.”³⁹ Of the 50 largest system clusters reported by SNL Kagan, 17 are owned by TWC, including two of the top 10 – Los Angeles and New York City.⁴⁰

49. Clustering directly increases the bargaining power of MSOs in negotiations for both regional (e.g., regional sports networks) and local content (e.g., broadcast signals). Bernstein Research notes that the negotiation of programming rights is often a function of local market share, and that as a result of clustering, cable operators often dominate local markets.⁴¹ A cable operator’s refusal to carry a local programming network can have devastating effects on the programmer, as MSOs and programmers realize losses asymmetrically. As Bernstein Research explains, “subscribers leave distributors [MSOs] only slowly, while advertising revenues [to programmers] are lost right away.”⁴² Moreover, because local and national rights negotiations are often combined, the increased leverage clustering gives MSOs in local and regional negotiations translates into increased leverage over national programming rights as well.

50. To summarize this section, the evidence demonstrates that the upstream side of the market for programming is highly competitive. There are more than 500 networks, no single firm controls more than about 15 percent of all programming, and the number of competitors is increasing; that is, the market structure is unconcentrated, and there are no barriers to entry. On the other hand, the downstream market is relatively concentrated at both the national level and the local level, where clustering has resulted in MSOs controlling large shares of local video distribution markets. Moreover, MVPDs can and do produce their own programming, but generally choose not to do so – a clear indication they are not paying supra-competitive prices.

39. Time Warner Cable Inc., Form 10-K, filed February 20, 2009, at 1 (emphasis added).

40. SNL Kagan, “Broadband Cable Financial Yearbook,” 2009 Edition.

41. Bernstein Research, *Cable and Satellite: Asymmetrical “Retrans” Leverage Favors Cable Over Satellite And Telcos*, (March 21, 2006) at 1.

42. *Id.*

V. CONCLUSIONS

51. MSOs have strong incentives to drive tough bargains with video programmers: Lower input prices translate directly into higher profits. It is therefore not surprising that they seek to enlist the support of both customers and government officials in their negotiations, by claiming that programming costs are the cause of higher cable rates. As this report demonstrates, however, programming costs are actually falling when compared with cable revenues, cable profits, and other elements of cable costs. Moreover, the competitive nature of the programming business suggests that programmers are not capable of charging higher-than-competitive license fees. Finally, while cable operators' total expenditures on programming have risen in recent years, they are the first to agree that they – and their customers – are getting their money's worth, in the form of more choices and higher program quality. In short, while negotiations between programmers and cable operators are, and are likely to remain, hard headed, the results are benefiting consumers.